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Outlook for the Economy and Real Estate

Forecasting & Policy
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The Outlook for the Economy and Real Estate

Growth of real (inflation-adjusted) Gross National Product (GNP) was revised down to an unexpected 0.6 percent annual rate during the second quarter. A further deterioration in growth of net exports and a downward adjustment of inventories contributed to the slowdown. A sharp decline in nonresidential investment also dampenened growth. However, the second quarter growth figure did conceal some strength in demand for domestically-produced goods which rebounded 6.8 percent. During the last half of the year, growth is expected to rebound modestly as most of the factors that contributed to the slowdown in the second quarter -- large increases in petroleum imports and a downward correction to inventories -- are not expected to re-occur and growth in consumption is expected to expand at a modest pace. As a result, growth is expected to rebound modestly to 2.3 percent during the third quarter and to 2.5 percent during the fourth quarter.

The outlook for the remainder of 1986 depends heavily on the performance of trade. In the absence of a sharp deterioration in net exports, the continued growth in domestic demand could stimulate a much-needed rebound in production and lift the manufacturing sector out of its current slump. However, the prospects of an improvement in the merchandise trade deficit have been clouded by recent monthly data. The July merchandise trade balance recorded a deficit of $18 billion, indicating a further deterioration from the June trade deficit of $14 billion rather than an improvement. The July report underscored the fact that the continued penetration of U.S. markets has to a large extent come from newly industrialized Asian countries, whose currencies have not appreciated against the dollar. Therefore, a further depreciation of the dollar against the Japanese Yen and the German Marc will not necessarialy lead to an improvement in the nations' trade performance. While it is likely that July's merchandise trade deficit will be revised down as more complete data on transactions are reported, a modest deterioration in the trade deficit is expected through the rest of the year, and as a result, growth during the second half will not be as strong as previously expected. However, if the trade deficit deteriorates markedly through the last half of the year, the probability of even a modest rebound will be diminished.

Deep-discounted auto financing and the imminent passage of tax reform are expected to bolster consumption over the next six months. Domestic automakers are offering interest rates between 0 and 2.9 percent in order to deplete inventories and make room for next year's models. As a result, new car sales by the "Big Three" automakers -- Ford, G.M. and Chrysler -- have responded favorably increasing 32 percent in early September over the same period last year. Further, repeal of the deductibility of sales taxes beginning in 1987 should induce consumers to accelerate purchases of big-ticket items during the later part of this year. However, while the boost to consumption is expected to sustain economic activity in 1986, it will be at the expense of growth in 1987.

The major factor dampening growth in 1987 will be tax reform. Retaining the basic qualitative features of the Senate and House proposals, the final conference committee bill will repeal the Investment Tax Credit (ITC) and lengthen the depreciation schedule for structures and most equipment thereby dampening overall investment spending next year. Another feature of the bill likely to dampen real estate investment is the loss limitation provision which prevents investors from using losses from real estate investments to offset other types of income. Fiscal restraint associated with Gramm-Rudmann-Hollings is also expected to place a considerable drag on the economy next year. Finally the pace of consumption will slow as rising debt burdens and smaller income gains stifle consumer spending. As a result growth for all of 1987 should reach only 1.7 percent.

The trend in oil prices continues to dominate the outlook for inflation. Oil prices have risen in response to the OPEC production restraint agreement. As a result, overall Consumer Price Inflation (CPI) should reaccelerate modestly to about a 3.3-3.8 percent rate through the end of this year with a 2.1 percent rate expected for all of 1986. By 1987, there will be two opposing forces influencing inflation--a depreciating dollar and continued slack in the labor markets. Putting upward pressure on prices, the impacts of a sharply depreciated dollar will boost import prices. Restraining inflation next year, slower wage gains will help to keep a lid on labor costs. As a result, by 1987, the CPI is expected to increase to about 3.5 percent before accelerating modestly to 4.0 percent in 1988.

The unemployment rate declined to 6.8 percent and nonagricultural payroll employment rose by a healthy 200,000 jobs in August indicating that growth should pick up during the last half of 1986. Within the goods-producing sector, manufacturing employment, which had been on a downward trend over the past 6 months held steady in August. In fact, over half of the manufacturing industries recorded modest increases over last month suggesting a possible end to the current slump in manufacturing. Construction employment also expanded at a healthy pace underscoring the strong growth in housing. In the service-producing sector employment increased by 65,000 jobs with the strongest gains in finance, insurance, and real estate. The unemployment rate is expected to remain near 6.9 percent through 1986, however, slower growth next year is expected to boost the unemployment rate to above 7.5 percent.

Fiscal Policy

The budget outlook has been complicated considerably by tax reform. The tax reform package gains revenues during the first year while losing revenues in 1988. Therefore, the expected shortfall in revenues in 1988 must be offset by further spending cuts if Congress hopes to reach the GRH targets. Further, any attempts by Congress to use the extra revenue in 1987 to meet the GRH targets will further endanger the targets in 1988. These revenue estimates are strongly affected by economic conditions. The budget projections by Office of Management and Budget (OMB) and Congressional Budget Office(CBO) are averaged to determine the growth rate used in projecting the budget. This average growth projection is 3.8 percent for next year. CBO and OMB are also projecting a higher rate of inflation, about 4 percent, which will raise estimates of nominal federal reveneus. If growth continues to remain sluggish and inflation remains below the average projection by OMB and CBO, as is highly likely, actual revenues will fall short of projections making it even harder for Congress to reach the GRH deficit for 1987 and beyond. Currently, we are forecasting growth in the economy of about 1.7 percent an inflation rate of about 3.5 percent. Therefore, the required spending cuts to meet GRH targets in fiscal year 1988 will be so large as to make GRH unworkable.

Monetary Policy

In mid-August the Federal Reserve cut the discount rate, the rate charged to member banks for loans, for the fourth time this year to 5-1/2 percent. Despite substantial declines in short term interest rates, long-term interest rates have been quite volatile and are higher than they were preceeding the second cut in the discount rate this year. Contributing to the volatility in long-term interest rates, the bond market remains jittery about a reacceleration of inflation as the recent agreement by OPEC members limiting production of oil has signaled a bottoming out of oil prices. Further, recent monthly indicators have hinted at a resurgence of growth during the last half of 1986 which could reignite inflationary pressures. However, the recent increase in interest rates will be reversed once credit markets realize that the current resurgence of economic growth will be

modest and short-lived. Therefore, the overall trend will be downward through next year as:

- o Sluggish growth is expected to persist through next year.
- o Tax reform should remove investment incentives, leading to less investment and therefore less demand for credit.
- o Fiscal restraint associated with Gramm-Rudmann-Hollings should provide greater assurance that future deficits should not rise.
- o Continued moderation in oil prices and slower wage gains should restrain expectations about future inflation

Real Estate Markets

Existing-home sales have responded favorably to the retreat in mortgage interest rates which has enhanced overall affordability. Existing sales in July increased to a seasonally-adjusted annual rate of 3.45 million units. Housing starts, on the other hand, declined by about 2 percent to 1.818 million units in July dampened by tax reform and regional variations. Healthy increases in single-family starts were recorded in the Northeast and Midwest, while declines occurred in the South and West largely because these regions have been experiencing economic problems resulting from slumping energy, mining and agricultural industries.

Over the next year, the benefits of lower mortgage interest rates should be diluted by tax reform and slower growth. While mortgage interest and state and local property tax deductions for homeowners would be maintained under tax reform, the increase in the standard deduction and the loss or limitation of several non-homeownership itemized deductions would increase the cost of homeownership relative to the price of other goods and services people consume. As a result, the demand for housing will be dampenened. Single-family starts are expected to decline about 7 percent to 1.37 units. About 3.40 million existing homes are expected to be sold in 1987, well below the 3.6 million level projected in the absence of tax reform. Further, the imminent passage of tax reform will remove investment incentives in rental residential units and has already begun to dampen multi-family construction which is expected to trend downward through 1987 declining by as much as 23 percent next year.

Nationwide, the median existing single-family home price fell $200 from June to July to $82,400 the second consecutive monthly decline. However, the July median price was a strong 7.4 percent ahead of the $76,700 median recorded a year earlier. Regionally, the largest annual price increase last month occurred in the Northeast, where a 20.0 percent rise to a median $106,300 was recorded. The West followed with a 10.2 percent increase to a median of $105,700. The Midwest posted a 6.3 percent annual gain to $64,000 and the South recorded a 1.9 percent increase to $79,000. Existing homes are expected to appreciate at 7.4 percent rate for all of 1986. By 1987, this rate of appreciation is expected to slow to about 4.7 percent as tax reform increases homeownership costs and dampens overall housing demand.

Contracting for office space is expected to decline to 245 square feet in 1986, a 28 percent decline over 1985, in response to vacancy rates near 20 percent and less generous investment incentives in the House-Senate tax proposal. Construction in the industrial sector will also slow considerably due to the current slump in manufacturing. As a result, new contracts for industrial building are expected to decline to 135 square feet, a 12 percent decline over 1985.

Table 1

September 1986

U.S. ECONOMIC OUTLOOK

	QUARTERS							YEARS				
	Actual		Forecast					Actual		Forecast		
	1986.1	1986.2	1986.3	1986.4	1987.1	1987.2	1987.3	1987.4	1984	1985	1986	1987	1988
AGGREGATE ECONOMY													
Gross National Product													
(billions of dollars)	4,149	4,180	4,230	4,286	4,336	4,379	4,429	4,480	3,765	3,998	4,211	4,408	4,642
% Change	6.2	3.0	4.9	5.4	4.7	4.1	4.6	4.7	10.5	6.2	5.3	4.6	5.4
% Change (w/out inflation)	3.8	0.6	2.3	2.5	1.9	1.0	1.6	1.5	6.4	2.7	2.5	1.7	2.1
Consumption	3.6	6.5	3.2	2.5	2.1	1.9	1.5	1.2	4.7	3.5	3.9	2.4	1.9
Durables	-1.8	16.4	0.7	1.3	0.2	1.2	0.7	0.9	12.7	7.8	3.5	1.7	1.9
Nondurables	6.5	8.4	3.4	2.4	2.1	1.7	1.4	1.3	3.6	1.6	4.4	2.5	1.8
Services	3.2	2.4	3.8	2.9	2.6	2.2	1.8	1.3	3.4	3.7	3.6	2.5	1.9
Residential Investment	11.0	13.5	-1.8	-4.4	-7.9	-9.0	-6.1	-4.0	14.3	3.9	7.1	-5.0	0.1
Nonresidential Investment	-15.1	-2.3	1.0	1.2	0.6	-2.1	-0.4	-3.0	16.9	9.3	-1.0	-0.3	0.2
Structures	-10.8	-38.6	0.0	3.1	1.8	-0.4	1.2	-1.6	11.1	7.7	-10.9	-2.2	1.0
Equipment	-17.0	19.9	1.4	0.4	0.1	-2.8	-1.1	-3.5	20.0	10.1	3.8	0.5	-0.1
Exports	7.1	-5.6	-0.5	3.7	6.9	6.5	7.0	5.6	6.2	-2.0	1.0	4.4	5.7
Imports	0.2	16.5	2.7	2.3	-0.6	-2.0	-3.2	-1.4	23.2	3.6	8.8	0.7	-1.0
Government Purchases	-12.3	9.8	3.0	9.5	-8.8	0.0	2.8	7.1	4.0	6.8	3.3	1.1	0.6
Contribution to GNP Growth (Percentage Point)													
Consumption	2.3	4.2	2.1	1.6	1.4	1.2	1.0	0.8	2.4	2.3	2.6	1.1	1.5
Residential Investment	0.5	0.7	-0.1	-0.2	-0.4	-0.5	-0.3	-0.2	0.2	0.4	0.2	-0.3	0.2
Nonresidential Investment	-2.1	-0.3	0.1	0.1	0.1	-0.3	-0.1	-0.4	1.7	0.8	-0.5	-0.2	0.2
Structures	-0.5	-1.8	0.0	0.1	0.1	0.0	0.0	-0.1	0.5	0.1	-0.6	0.0	0.0
Equipment	-1.6	1.6	0.1	0.0	0.0	-0.2	-0.1	-0.3	1.2	0.7	0.0	-0.2	0.1
Inventory Change	5.1	-3.1	0.0	-1.0	2.0	-0.4	-0.6	-0.9	0.2	-1.1	0.2	0.0	0.0
Net Exports	0.7	-2.7	-0.4	0.0	0.7	0.9	1.1	0.8	-1.4	-1.1	-0.6	0.9	0.6
Government Purchases	-2.6	1.9	0.6	1.9	-1.9	0.0	0.6	1.4	1.5	1.6	0.4	0.0	0.1
Mfg. Capacity Utilization Rate	79.9	79.2	78.2	78.3	78.2	77.8	77.6	77.5	80.8	80.3	78.9	77.8	77.9
Domestic Auto Sales	7.8	8.1	7.9	7.8	7.5	7.4	7.2	7.1	8.0	8.2	7.9	7.3	7.1
Personal Income Per Household	41,477	42,023	42,196	42,595	43,038	43,409	43,810	44,212	38,154	40,285	42,065	43,623	45,491
Percent Change -- Year Ago	4.5	4.7	4.6	4.0	3.8	3.3	3.8	3.8	8.6	5.6	4.4	3.7	4.3
Personal Taxes Per Household	6,011	6,084	6,143	6,231	6,092	6,179	6,269	6,359	5,393	5,913	6,117	6,226	6,046
Percent Change -- Year Ago	-1.0	9.6	3.0	2.8	1.4	1.5	2.1	2.1	8.2	9.6	3.4	1.8	-2.9
Percent of Personal Income	14.5	14.5	14.6	14.6	14.2	14.2	14.3	14.4	14.1	14.7	14.5	14.3	13.3
Disposable Personal Income Per Household	35,466	35,939	36,052	36,365	36,946	37,231	37,540	37,853	32,761	34,372	35,948	37,397	39,445
Percent Change -- Year Ago	5.5	3.9	4.9	4.3	4.2	3.6	4.2	4.1	7.1	4.9	4.6	4.0	5.5
Employment (millions)	108.8	109.2	109.7	109.7	109.9	110.0	110.2	110.4	105.0	107.2	109.4	110.1	111.3
(civilian:household basis)													
% Change	2.9	1.7	1.7	0.1	0.7	0.4	0.7	0.7	4.1	2.1	2.0	0.7	1.0
Unemployment Rate (%) (civilian)	7.1	7.2	7.0	7.2	7.4	7.6	7.7	7.8	7.5	7.2	7.1	7.6	7.7
Consumer Prices (CPI)	1.4	-1.7	3.3	3.8	4.1	3.8	4.2	3.8	4.3	3.5	2.1	3.5	4.0
GNP Deflator	2.5	2.5	2.4	2.9	2.8	3.0	3.0	3.2	3.9	3.3	2.8	2.8	3.2
Personal Cons. Inflation	1.1	-0.7	3.2	3.7	3.9	3.6	3.9	3.6	3.8	3.5	2.2	3.4	3.7
Residential Construction Inflation	3.0	7.5	3.1	3.2	3.6	3.6	3.8	3.9	4.1	1.8	3.8	3.7	4.1
Nonresidential Const. Inflation	3.7	0.0	1.1	2.4	2.8	3.3	3.1	3.6	-0.2	0.7	1.3	2.5	3.6
Producer Price Inflation	-5.8	-5.1	1.5	2.5	3.9	3.6	4.2	3.8	2.1	0.9	-1.2	2.7	4.0
Before-Tax Corporate Profits	224.3	231.9	250.9	267.9	282.8	261.9	268.0	273.7	235.7	223.1	243.8	266.6	286.7
Corporate Tax Liability	89.1	91.1	105.7	113.1	141.5	139.8	121.5	124.1	95.4	91.7	99.6	131.7	129.0
After-Tax Profits	135.2	140.8	145.2	154.8	121.3	122.1	146.5	149.6	140.3	131.4	144.0	134.9	157.7
Inventory Valuation Adjustment	16.5	7.9	-3.9	-4.4	-8.2	-6.2	-6.6	-4.7	-5.5	-0.5	4.0	-6.4	-5.5
Capital Consumption Allowance	55.6	51.4	52.0	51.6	48.7	45.0	41.4	37.8	34.5	58.1	52.7	43.2	27.5
Federal Tax Receipts (NIPA)	800	806	826	839	864	872	863	875	727	787	818	858	864
% of GNP	19.3	19.3	19.5	19.6	19.9	19.9	19.5	19.5	19.3	19.7	19.4	19.7	18.6
Federal Expenditures (NIPA)	1,002	1,043	1,034	1,067	1,048	1,056	1,072	1,098	897	985	1,036	1,069	1,105
% of GNP	24.1	24.9	24.4	24.9	24.2	24.1	24.2	24.5	23.8	24.6	24.6	24.3	23.8
Deficit(NIPA)	-202	-237	-209	-228	-184	-184	-210	-224	-170	-198	-219	-200	-241
% of GNP	4.9	5.7	4.9	5.3	4.2	4.2	4.7	5.0	4.5	4.9	5.2	4.5	5.2
% of Net Domestic Savings	59.7	72.9	73.1	79.9	71.5	75.1	81.2	87.5	51.8	63.4	70.9	78.8	82.9

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. Richard Peach, Janemarie Mulvey, and Sean Burns.

Table 2

September 1986

REAL ESTATE AND FINANCIAL MARKETS

	QUARTERS						YEARS				
	Actual		Forecast				Actual		Forecast		
	1986.1	1986.2	1986.3	1986.4	1987.1	1987.2	1987.3	1987.4	1984	1985	1986	1987	1988
REAL ESTATE AND FINANCIAL MARKETS													
Total Single-Family Home Sales (single-family resales and completions)	4,472	4,670	4,645	4,680	4,573	4,522	4,492	4,453	3,933	4,254	4,617	4,510	4,534
Percent Change -- Year Ago	11.3	14.5	6.1	3.1	2.3	-3.2	-3.3	-4.9	4.9	8.2	8.5	-2.3	0.5
Existing Single-Family Home Sale	3,257	3,470	3,480	3,499	3,447	3,410	3,390	3,359	2,868	3,214	3,427	3,402	3,418
Percent Change -- Year Ago	10.3	14.0	3.6	0.0	5.8	-1.7	-2.6	-4.0	5.5	12.1	6.6	-0.7	0.5
Dollar Volume (billions)	307	349	351	348	344	355	358	352	247	291	339	352	372
Existing Home Prices - Median ($1000's)	78.1	82.0	82.8	81.4	81.7	85.8	86.8	85.4	72.3	75.5	81.1	84.9	88.8
Percent Change -- Year Ago	4.6	8.6	8.1	8.2	4.6	4.7	4.8	4.9	3.6	4.4	7.4	4.7	4.6
Monthly Mortgage Payment (P&I, 80%, 30 yr.)	584	587	585	564	551	561	553	538	618	609	580	551	531
Percent of Median Family Income	24.8	24.7	24.5	23.4	22.7	23.0	22.7	22.0	33.0	29.4	24.4	22.6	21.7
Housing Starts (1000's)	1,998	1,908	1,830	1,783	1,691	1,660	1,628	1,609	1,763	1,741	1,880	1,647	1,682
Percent Change	61.3	-16.9	-15.4	-9.9	-19.1	-7.1	-7.6	-4.4	3.4	-1.2	8.0	-12.4	2.1
Single-Family Units (1000's)	1,253	1,237	1,201	1,218	1,161	1,144	1,124	1,120	1,100	1,073	1,227	1,137	1,159
Percent Change	85.1	-4.8	-11.2	5.8	-17.4	-5.9	-6.6	-1.4	3.3	-2.5	14.4	-7.3	1.9
Multi-Family Units (1000's)	746	671	629	565	529	516	503	489	663	669	653	510	523
2-4 Family Units	102	81	76	68	64	62	61	59	122	93	82	62	63
Percent Change	168.7	-60.2	-22.6	-35	-22.8	-9.6	-9.8	-10.7	7	-23.4	-12.1	-24.6	2.6
5+ Family Units	644	590	553	497	466	454	442	430	542	576	571	448	460
Percent Change	16.4	-29.6	-22.6	-35	-22.8	-9.6	-9.8	-10.7	2.8	6.2	-0.9	-21.5	2.6
Mobile Homes Shipped	262	238	240	245	241	242	242	244	295	283	246	242	255
New Single Family Home Sales (1000's)	800	787	725	695	668	670	655	650	637	689	752	661	634
Percent Change -- Year Ago	19.9	15.7	2.0	-0.1	-16.5	-14.9	-9.7	-6.5	1.3	8.1	9.2	-12.1	-4.1
New Home Prices -- Median ($1000)	88.3	91.6	93.1	94.5	94.7	94.8	94.7	94.6	80.0	84.3	91.9	94.7	98.1
Percent Change -- Year Ago	6.2	9.0	12.0	9.6	8.1	4.0	1.8	0.0	6.0	5.4	9.1	3.0	3.6
New Home Prices -- Mean ($1000's,Quality Adj.)	103.2	107.8	108.6	109.7	107.7	111.5	112.4	113.8	96.8	104.0	107.3	111.3	115.8
Percent Change -- Year Ago	2.0	3.6	4.1	3.1	4.3	3.4	3.5	3.7	6.6	7.4	3.2	3.7	4.0
NAR Affordability Index	100.6	101.1	101.8	106.4	109.9	108.5	110.1	113.6	89.1	95.5	102.2	110.6	115.1
Mortgage Debt Outstanding($ billions)	2,303	2,389	2,409	2,478	2,555	2,629	2,702	2,775	1,948	2,202	1,819	2,665	2,960
Housing Inventory (millions)	96.3	96.8	97.3	97.7	98.2	98.6	99.0	99.4	93.4	95.2	97.0	98.8	100.4
Rental Vacancy Rate (%)	6.9	7.3	7.3	7.3	7.2	7.2	7.1	7.0	5.8	6.5	7.2	7.1	6.9
Office Vacancy Rate (%)<1>	16.3	16.8	16.8	16.9	17.0	16.8	16.7	16.6	14.7	16.5	16.7	16.8	16.5
Industrial Vacancy Rate (%) <1>	5.3	5.7	5.8	5.7	5.7	5.6	5.6	5.5	4.7	5.0	5.6	5.6	5.4
FINANCIAL MARKETS													
Money Supply (M1)(% change)	7.9	16.8	13.1	11.0	9.3	7.5	6.5	5.8	7.0	9.1	12.1	9.6	6.2
Velocity of M1 (% change)	-1.6	-11.8	-7.3	-5.0	-4.2	-3.2	-1.8	-1.0	3.3	-2.6	-6.0	-4.6	-0.8
Value of the U.S. Dollar (Trade-Weighted)	119.5	114.2	108.0	106.0	105.2	104.4	103.6	102.8	138.3	143.2	111.9	104.0	100.9
Percent Change	-24.5	-16.5	-20.1	-7.2	-3.0	-3.0	-3.0	-3.0	10.4	3.5	-21.9	-7.1	-3.0
Flow of Funds (NIA Basis) (Billions of dollars,saar)													
Sources:(total:gross savings)													
Private Saving	715	719	686	689	668	665	686	692	675	688	702	678	746
Personal Saving	146	153	124	113	127	117	111	109	169	143	134	116	149
Savings Rate	5.0	5.1	4.1	3.7	4.1	3.8	3.5	3.4	6.3	5.1	4.5	3.7	4.5
Gross Business Savings	569	566	563	576	542	548	575	583	506	544	568	562	597
Federal Deficit	-202	-237	-209	-228	-184	-184	-210	-224	-170	-198	-219	-200	-241
State & Local	70	60	57	60	60	59	59	59	69	62	62	59	61
Net Foreign Investment	129	138	139	149	153	157	157	156	91	115	139	156	153
Uses (total:gross investment)	708	685	688	682	702	696	691	682	662	681	691	693	719
Nonresidential Investment	458	455	456	458	458	456	455	452	422	461	457	455	456
Structures	148	131	131	132	133	133	133	132	141	152	136	133	134
Equipment	310	324	325	326	326	323	323	320	281	309	321	323	323
Residential Investment	186	192	191	189	185	181	178	177	171	177	190	180	181
Inventory Investment ($ Billions)	40	12	12	3	21	17	10	1	59	9	17	12	12
Selected Interest Rates (%)													
Mortgage Rates													
30-year Fixed Rate Mortgage<2>	10.4	9.9	9.8	9.5	9.3	9.1	9.0	8.9	13.8	12.2	9.9	9.1	8.6
Real Mortgage Rate<3>	4.4	4.4	4.6	4.7	4.9	4.9	5.1	5.3	6.4	5.5	4.5	5.1	5.3
1-year ARM (without buydown)	9.2	8.3	7.7	7.5	7.3	7.2	7.1	7.0	12.6	10.1	8.2	7.2	6.9
Real Mortgage Rate	3.2	2.7	2.5	2.7	2.9	3.0	3.2	3.4	5.2	3.4	2.8	3.1	3.6
Corporate AAA Bond Rate	9.6	9.0	8.9	8.6	8.2	7.8	7.7	7.6	12.7	11.4	9.0	7.8	7.4
Government Bond Rate	8.9	7.7	7.5	7.3	7.0	6.8	6.7	6.6	12.5	11.0	7.8	6.8	6.4
Real Government Bond Rate	2.9	2.2	2.3	2.5	2.6	2.6	2.8	3.0	5.1	4.3	2.4	2.8	3.1
Federal Funds Rate	7.8	6.9	6.3	6.0	5.8	5.7	5.6	5.5	10.2	8.1	6.7	5.6	5.4
3-month T-Bill Rate	7.0	6.1	5.5	5.3	5.1	5.0	4.9	4.8	9.5	7.5	6.0	4.9	4.7
Real 3-month T-Bill Rate	4.5	3.6	3.1	2.4	2.3	2.0	1.9	1.6	5.6	4.2	3.2	2.1	1.5
1-Year T-Bill Rate	7.5	6.6	6.0	5.8	5.6	5.5	5.4	5.3	10.9	8.4	6.5	5.5	5.2
Real 1-Year T-Bill Rate	5.0	4.1	3.6	2.9	2.8	2.5	2.4	2.1	7.0	5.1	3.7	2.7	2.0
Prime Rate	9.4	8.6	7.8	7.5	7.3	7.2	7.2	6.9	12.0	9.9	8.3	7.1	6.5
Discount Rate	7.4	6.6	5.8	5.5	5.3	5.2	5.0	4.8	8.8	7.7	6.3	5.1	4.8

<1> Historical Data courtesy of Coldwell Banker.
<2> FHA Secondary Mortgage Market Rate
<3> Real Interest Rates = Nominal Interest Rates - Expected Rate of Inflation.

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. Richard Peach, Jeneamarie Mulvey, and Sean Burns.

Special Supplement:

The Falling Dollar and the U.S. Merchandise Trade Deficit

In July, 1986, the U.S. merchandise trade deficit rose to $18.04 billion. This means that imports to the U.S. exceeded exports by the largest monthly margin ever recorded. For the first half of 1986, the trade deficit was $83.9 billion. At the current monthly pace, it could reach almost $200 billion for all of 1986. For reference, the merchandise trade deficit just five years ago amounted to only $28 billion for all of 1981. These large trade deficits have seriously hampered economic growth, being cited as a contributing factor to the recent anemic performance of the U.S. economy.

Beginning in the 1970's, high inflation rates became a built-in factor in planning decisions made by individuals and businesses. These inflation expectations led financial institutions to increase the interest rates they charged to reflect the anticipated higher operating costs. The combination of inflation and high interest rates in the late 1970's attracted foreign capital seeking these higher rates of return available on U.S. investments. Of course, to make these investments foreign investors needed U.S. dollars. This created demands for dollars above and beyond the normal requirements for international trade and capital flows, which raised the price of the dollar in world foreign exchange markets. Deficit federal spending throughout the 1980's has increased the government's demand for credit which in turn has kept real interest rates at very high levels. These high real interest rates available on U.S. investments have sustained foreign investment in the U.S. and resulted in additional demand for the U.S. dollar.

Normally, such a rise in the value of the dollar benefits U.S. consumers because it increases their buying power in world markets. However, the higher dollar was not at first a bonus to U.S. consumers because the economy was suffering through a severe recession in 1981-1982. But as economic growth rebounded in 1983 and came roaring back in 1984, consumers' incomes also rose, allowing them to finally take full advantage of the strong dollar and use it to go on a worldwide buying spree. In the process, U.S. consumers passed over U.S. manufactured goods, instead preferring imported goods selling for unusually low prices due to the high dollar.

Not only did the strong dollar leave U.S. manufacturers hard-pressed to find a market for their products at home, but they were also losing their share of foreign markets that had usually shown strong demand for U.S. exports. This happened because, just as a strong U.S. dollar had made foreign goods cheaper for U.S. buyers, it also made U.S. goods more expensive to buyers in overseas markets. In addition, many foreign countries were not experiencing the same robust economic growth as the U.S., which further weakened foreign demand for U.S. goods. This combination of a strong dollar, rising personal incomes at home and weak foreign demand for U.S. exports were the major factors in the buildup to the high merchandise trade deficits we have today.

In February, 1985, the U.S. dollar began a slow decline. The debate was joined on whether to accelerate the dollar's drop. Many argued that too fast a drop in the dollar's value could re-ignite inflation in the U.S. by raising import prices and thereby reducing price competition for domestic firms. However, the strong pressures of mounting monthly trade deficits mandated that a U.S. policy response be formulated. In September, 1985, a meeting of world finance ministers from the leading industrial nations was called to discuss the decline of the U.S. dollar. The G-5 meeting, as the group came to be known, did succeed in agreeing to and later orchestrating further dollar declines. The hope was to correct world trade imbalances by first shrinking the largest one of them all--the U.S. merchandise trade deficit--through declines in the value of the dollar. Today, the dollar is roughly 30 percent below its average value against other major currencies in February, 1985, and 40 percent lower against the Japanese Yen and German Deutschmark. Since the outset, economists have maintained that a long lag exists between changes in the dollar's value and subsequent changes in the trade deficit. However, lower merchandise trade deficits have yet to materialize apparently because the traditional inverse relationship between the dollar and trade deficits may be subject to a longer lag than is usually the case.

Not surprisingly, many reasons have been offered to explain the longer lag in the dollar-trade deficit relationship that has caused the trade deficit to remain so painfully high. Today, few economists still believe this alone explains the lack of improvement in the trade deficit since the dollar's slide began more than 18 months ago. One generally accepted explanation for the longer lag is that foreign producers of goods exported to the U.S. have trimmed their profit margins more than expected in response to the weaker dollar. The weaker dollar has effectively made foreign goods more expensive to U.S. consumers, but by absorbing some of this added cost (by not increasing prices on their goods by the full amount of the dollar's fall) foreign producers hope to lessen the impact of the falling dollar on U.S. import prices and preserve their share of the lucrative U.S. market. At the same time, some U.S. firms have raised their prices rather than try to take advantage of the dollar's fall to increase their U.S. market share. These U.S. firms are working to restore their profit margins that suffered when the dollar was strong.

A second explanation given concerns the export side of the U.S. merchandise trade deficit. A weaker dollar makes U.S. exports more affordable to consumers in foreign markets. Typically, this sparks increased demand by foreign consumers for U.S. exports. However, many of those foreign markets which have been profitable for U.S. firms in the past are not experiencing economic growth strong enough to support an influx of U.S. goods. Unfortunately, this has continued to be the case despite the lower prices brought on by the weak dollar. For example, economic growth in West Germany and Japan has been relatively weak lately. In fact, U.S. officials have repeatedly asked these two nations to stimulate their respective economies in the hopes of reviving demand for U.S. exports.

A third reason given is that the U.S. dollar has not declined against the currencies of all our trading partners. While it has fallen against the currencies of our major trading partners, there is still a large group of individually small trading partners whose currencies have changed very little

in relation to the dollar. Some economists estimate this group to collectively account for almost half of the U.S. merchandise trade deficit. Most significant in this group, along with their share of the U.S. trade deficit, are Taiwan ($1.7 billion), South Korea ($838 million) and Hong Kong ($644 million). The U.S. dollar has fallen less than 10 percent against the currencies of Taiwan and Hong Kong, and actually risen slightly against the currency of South Korea. These countries have not experienced the pressures that a weaker dollar brings to bear on prices offered by foreign producers, and so little improvement in these trade balances is expected.

A fourth reason is that while U.S. imports are valued at the new dollar exchange rate, they are shipped for a time at the same volume because of a lag between changes in the exchange rate and the volume of physical shipments by foreign exporters. This means that the trade deficit can widen in dollar terms yet be the same in volume terms. An example using Japanese exports of Toyota cars to the U.S. is a good way to explain this phenomenon. Before the recent drop in the value of the dollar, the exchange rate of Japanese yen for U.S. dollars was 180 yen per dollar, and a Toyota car exported from Japan at a price of say, 1,800,000 yen would have retailed at $10,000 in the U.S. The exchange rate is now about 150 yen per dollar and the same Toyota car exported to the U.S. would now retail for $12,000. There is a lag of about 3 to 6 months between the change in the yen-dollar exchange rate and a subsequent change in the volume of these shipments. During this lag the volume of Toyota cars remains about the same yet the change in the exchange rate has raised the price of these cars in the U.S. This results in a larger trade deficit with Japan in dollar terms, even though in volume terms shipments of Toyotas have remained the same. So, in some cases a declining dollar can actually appear to temporarily widen the trade deficit.

While there are many explanations offered for why the merchandise trade deficit is so large, how to reduce it given the now uncertain relationship between it and the U.S. dollar is an unsolved puzzle. Further declines in the dollar, often cited as the answer, may also lead to another round of accelerating inflation. Presumably the Federal Reserve Board would be called upon to lower interest rates as a prelude to more dollar declines. However, the Fed, having supposedly rid the economy of inflation, has been easing its grip on the money supply in order to compensate for the shift away from fiscal policy as the engine of economic growth. The Fed now has the unenviable dual task of deciding how low interest rates should fall to keep the economy afloat, while also keeping watch for a resurgence of inflation from faster money supply growth and the falling dollar.